

T E S T I M O N Y

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Competitive Sourcing and the Morale of Federal Employees

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Mr. Chairman and members of the Subcommittee, thank you for the invitation to testify before you today. It is a particular privilege to testify before Senator Pryor today. I served with your father on the congressionally mandated Commercial Activities Panel (CAP) last year and learned a great deal from him. My testimony today draws on that work² and, more generally, on policy analysis I have done at RAND.³ In today's testimony, however, I speak as an individual.

I share your belief, Mr. Chairman, that we should treat the government's career employees with respect and appreciation. Competition affects every person's sense of self-respect throughout our society. Some federal employees fear competition, because they are convinced that they and their colleagues cannot—or will not be allowed to—compete successfully against an alternative commercial source. That cannot be good for morale, whether competition occurs or not. Can such organizations hope to recruit the kind of employees we need in the federal workforce? Thousands of other federal employees have affirmed their self-respect by helping their federal colleagues win public-private competitions. To me, two critical challenges for competitive sourcing policy itself are to (1) ensure that we properly empower federal employees to compete and (2) create as level a playing field as possible for them to compete on and prove themselves.⁴

Let me offer the following observations:

1. Competitive sourcing is one of the best tools we have available to improve the cost-effectiveness of federal agencies. In its efforts to improve productivity since 1996, for example, the Department of Defense has consistently preferred this as the option with the best-documented history of improvement.⁵
2. RAND analysis on the best commercial sourcing practices indicates that the following conditions improve the morale of the workforce in a company deciding whether or not to outsource an activity.⁶ Empirical information on commercial practice collected by the Commercial Activities Panel is consistent with these findings:

- The sourcing decision process is fair, objective, and transparent enough for employees to understand the final decision. The decision that such a process yields is more likely to enhance the long-term health of the company involved and so the long-term growth opportunities for employees who remain.⁷
- The decision process proceeds rapidly. Employee morale suffers most while awaiting a decision and suffers more, the longer the process takes.⁸
- Key employees are protected and encouraged to remain with a variety of incentives. This is obviously most important to the morale of the key personnel, but it also helps others who depend on their skills for their own job security.⁹
- Displaced employees are assured employment elsewhere in a firm. Employment elsewhere may require relocation or a lower job classification and commitments to retrain, but the option of remaining in the firm can limit the loss that an employee expects.¹⁰
- Displaced employees receive a soft landing if they leave a firm. This can occur through (1) formal severance or outplacement agreements with the firm if it outsources their positions, or (2) criteria used to choose an external source that reward a provider with generous compensation, benefit, and training programs and good opportunities for advancement.¹¹ A soft landing affects the morale of both the employees displaced and the employees who remain and watch these employees be displaced.

3. In well-managed outsourcing programs in the commercial sector, displaced workers often find themselves better off. Their new employers, who specialize more in their skills than their original employers did, are often more willing to invest in them and more likely to offer them growth opportunities.¹² That said, we must recognize that individuals who self-select into government jobs may simply not like jobs in the private sector, even if they offer better opportunities than the government did.

4. OMB's goal of competing 50 percent of positions in commercial activities in the federal government has clearly raised concerns among many in the federal workforce. Even though OMB has repeatedly clarified that it does not view this policy as an outsourcing program, employees afraid of outsourcing could easily misinterpret the policy's intent. RAND's analysis has long supported the strong empirical findings by the Center for Naval Analyses (CNA) that OMB Circular A-76 achieved savings through competition, not outsourcing.¹³ OMB's recent changes in Circ. A-76 emphasize that it is a competitive sourcing policy, not an outsourcing

policy.¹⁴ OMB's policy echoes that of the Department of Defense (DoD) in the 1990s, which emphasized competitive sourcing, because it had the best track record for improving government cost-effectiveness.¹⁵

Is 50 percent the right goal? It cannot be the right goal for every agency. A reliable method does not yet exist to determine exactly where competitive sourcing is cost-effective in any agency, even in DoD, the agency with the most experience in the federal government.¹⁶ I would prefer an OMB policy that motivated competitive sourcing with targets that had more operational or strategic significance to federal managers, like specific targets for cost reductions or performance improvements.¹⁷ For me, OMB's 50 percent goal is what the Commercial Activities Panel rejected as an "arbitrary numerical goal." I know that OMB disagrees.

5. That said, I think OMB has done a remarkably good job of implementing key elements of the Commercial Activity Panel's recommendations that it can control. I generally agree with Comptroller General David Walker's careful delineation of differences between the Panel's recommendations and OMB's new version of Circ. A-76.¹⁸ I will not even attempt to list them here. Rather, I would direct your attention to the extent to which the new version of Circ. A-76 captures the central elements of the Panel's strong consensus on principles.¹⁹ Taken together as a coherent whole, these principles call for major changes in competitive sourcing policy. OMB's recent revision of Circ. A-76 captures many of these changes in an effectively integrated manner.

6. From the perspective of employee morale, I think the following issues merit your further attention as OMB implements its new version of competitive sourcing:

- Are federal agencies actually giving their employees the support they need--in training, analytic support, and slack time--to participate effectively in public-private competitions? If they are not, the competitions cannot be fair and could well yield outcomes that do not serve taxpayers well either. OMB's decision not to program for the costs of competitions in its FY04 budget submission raises some concern. But I would be much more concerned if agencies were not devoting appropriate resources to these competitions.²⁰ The sooner agencies make appropriate investments to initiate well organized competitive sourcing under OMB's revised Circular A-76, the better.

- More broadly, are federal agencies investing in their internal processes to make them as cost-effective as possible? A central goal of extensive competitive sourcing is to induce such improvement across the board. To take full advantage of the power of public-private competitions, federal agencies will ultimately have to consider the past performance of federal activities as a selection criterion in these competitions.²¹ Unless federal employees believe that their managers are investing in their capabilities in good faith, they will resist evaluation of their past performance or consider it an unfair criterion.
- Does the government “offeror” have an effective way to protest elements of competitive sourcing or final decisions as effectively as external offerors can? What is the best way to level the playing field in this portion of the competitive sourcing process? Giving public unions standing will not level the playing field unless private unions also get standing, which makes little sense to me. But until this matter is resolved, government employees can legitimately argue that they are not being treated fairly.
- Broadly applied competitive sourcing will displace large numbers of federal workers from the federal workforce—far more than it has in the past. That is an inevitable outcome of any effective effort to improve the productivity of the federal government. I favor more flexible Office of Personnel Management policies to provide a soft landing for these employees, particularly when a decision to outsource degrades their pension benefits.²²

Thank you again for the opportunity to testify here today. I would be happy to answer any questions.

¹ I thank Michele Anandappa, Frank A. Camm, Ray Conley, Susan Gates, Henry Leonard, Nancy Moore, Wendy Moltrup, and Shirley Ruhe for helping me prepare this testimony. The opinions and conclusions expressed here are mine alone and should not be interpreted as representing those of RAND or of any of the sponsors of RAND’s research.

² See Commercial Activities Panel, 2002.

³ Much of this work is summarized in Camm, 2002; and Johnson *et al.*, 2003, pp. 211-246. The work provides the basic policy context for Anderson, 1999.

⁴ The very view of employees as “human capital” implicitly envisions individuals with skills that they can carry with them from one employer to the next. Increasingly, the notion of “job

security” in the private sector emphasizes an employee’s ability to acquire useful skills and apply them wherever relevant opportunities are available, not lifetime employment in one company. Exposing federal employees to competition and investing in them to help them compete successfully can be viewed as an integral part of a broader human capital policy designed to help prepare federal employees for successful life in today’s economy.

⁵ In 1996, the Office of the Secretary of Defense gave each of the armed services goals for improvement. The Quadrennial Defense Review (QDR) of 1997 documents the strategies they chose to meet these goals. Attracted by the carefully documented history of DoD’s experience with competitive sourcing, all of the services placed heavy reliance on competitive sourcing relative to any other option. They have since shifted their emphasis to include other ways to improve performance but, among these, only competitive sourcing has a well-documented history of success in the federal government. See Cohen, 1997.

⁶ “Best commercial sourcing practices” are the practices that (1) private firms use to choose and manage sources and (2) their peers consider to be “best in class.” Commercial firms use a “make-or-buy” process to decide what to outsource. The process differs substantially from firm to firm. We have never observed a process in the commercial sector as formal and transparent as that defined by the Office of Management and Budget’s (OMB) Circular A-76. Commercial firms usually use a process closer to an administrative benefit-cost analysis than to a formal source selection. Among the most transparent commercial processes are those in which companies work with their employees’ unions to ensure fair and objective decisions. Most firms examined in RAND analysis consider employee morale a key factor in make-or-buy decisions and attempt to design make-or-buy decisions that sustain employee morale relevant to business success.

⁷ In the commercial firms that RAND examined, employees increasingly appreciate that their future opportunities in the firm depend on its business success and that success depends on cost-effective sourcing decisions. They clearly understand that sourcing decisions must reflect the firm’s strategic goals. These firms can plausibly argue that, when internal process improvements improve their competitiveness in the market place, the improvements open the opportunity for corporate expansion and increased employment. A fair, objective, transparent make-or-buy decision process helps verify that any decision in fact reflects the firm’s broader interest and is not motivated by the personal interests on a specific manager, a vindictive view

of specific workers, or some other illegitimate motive. The survival of government agencies does not depend cost-effective make-or-buy decisions, and a federal agency can rarely increase demand for its employees' work by improving their productivity. A fair, objective, transparent make-or-buy decision process protects government employees more against the inappropriately political decisions of a government manager than against the effects of bad business decisions on the success of their employer.

⁸ In the past, many defended the lengthy A-76 process as a buffer that gave employees time to come to terms with change. Commercial firms have generally found that their employees like neither change nor uncertainty. But if change must come, doing it quickly can resolve uncertainty so that employees can get on with their lives. Morale suffers during a commercial make-or-buy decision process and can fall so low that workers leave, effectively leaving the firm without a viable option of keeping work in-house. The costs of low morale can be so high that some firms are willing to sacrifice reliability in their estimates of the costs and benefits of in-house and contract options to avoid transition costs.

⁹ The best employees—the employees with the best external opportunities—often leave a commercial firm as soon as a make-or-buy decision process starts. Commercial firms can sign agreements with key personnel to retain them through a sourcing decision and beyond if necessary. The retention of key personnel keeps skills in-house that are relevant to the decision process itself and to continuing in-house execution if the firm decides against outsourcing. Retention of key personnel can also stabilize the work force as a whole during a sourcing decision, moderating the negative effects of employee morale on business performance. Watching respected peers leave easily leads remaining workers to believe outsourcing is more likely.

¹⁰ Most of the government employees displaced by early outsourcing in DoD through A-76 could move elsewhere in DoD if they chose to. “Bumping” and other government personnel management techniques allowed them to retain their pay and benefit levels for a period of time that could potentially allow them to gain new skills. “Bumping,” of course, allows an employee displaced by an A-76 study to displace another, less senior employee elsewhere in the government, spreading the negative effects of the initial study on government employee morale. For more information, see Robbert et al., 1997; Gates and Robbert, 2000.

¹¹ “Best in class” commercial firms use a broader range of tools than those available to the federal government, suggesting that greater flexibility could help the government create a better safety net for displaced employees. Federal law currently requires that federal contractors pay at least the prevailing wage rates for specific skills and regions. (See, for example, provisions of the Service Contract Act [especially § 351, “Required Contract Provisions; Minimum Wages”] and the Davis-Bacon Act.) This provides some protection for displaced workers. In principle, the Federal Acquisition Regulation allows government agencies to consider more aggressive protection of displaced workers in the source selection criteria for competitions. By requiring that DoD use only minimum-cost public-private competitions, current congressional legislation prevents DoD from pursuing such protection. See 10 USCS § 2462, “Contracting for Certain Supplies and Services Required When Cost Is Lower.” Added July 19, 1988, P.L. 100-370, § 2(a)(1), 102 Stat. 851.

¹² Many firms also outsource to place their employees on a lower wage scale. This generally occurs in companies whose core competencies rely on highly skilled and well-paid employees, but who also require input from lower-skilled employees. These firms find it easier to outsource than to institute separate pay scales for high- and low-skill workers. The federal government could in principle pursue a similar policy, but nothing in policy or law requires it to. Low-skilled federal workers face such a risk only if the federal government chooses such an approach. Whether or not to pursue such an approach to competitive sourcing must be an integral part of the government strategy of sourcing.

¹³ See, for example, Marcus, 1993; Tighe *et al.*, 1996a; Tighe *et al.*, 1996b.

¹⁴ For example, Angela Styles, director of the Office of Federal Procurement Policy, has repeatedly explained that direct conversions were not compatible with a policy focused on competitive sourcing and so would no longer be allowed in cases under OMB’s control following the most recent revision of Circ. A-76. See, for example, Peckenpaugh, 2003.

¹⁵ DoD called its initial efforts, during the mid-1990s, to renew its use of Circular A-76 “outsourcing.” As the principals involved came to understand how Circular A-76 actually worked, they quickly renamed these efforts “competitive sourcing” and pursued an approach that was neutral about whether a task remained in-house or not.

¹⁶ The government currently uses comparatively primitive methods to distinguish positions that should be competitively sourced from those that should not. The methods differ across agencies. They are likely to overstate the opportunities suitable for competitive sourcing in some areas and understate them in others. Until the government uses better methods to implement the Federal Activities Inventory Reform (FAIR) Act inventory, it will be hard to interpret what percentage goals set for individual agencies even mean. Best commercial practice offers valuable lessons on how to improve these methods. The most obvious is to rely on the users of any activity inside an agency to determine whether it should be competitively sourced, not managers or workers within the activity itself.

¹⁷ Best commercial practice attempts to link key decisions to high-level strategic goals, like performance and total ownership cost. Firms that use this approach motivate their executives responsible for sourcing decisions with metrics that reflect these high-level goals. We have not encountered a metric like “percentage of positions studied” in the commercial firms we have examined. For more information, see Baldwin et al., 2000; Kaplan and Norton, 1996; Moore et al., 2002.

¹⁸ See, for example, Walker, 2003a; Walker, 2003b. I agree whole-heartedly that the key to the success of OMB’s changes in Circular A-76 lies in their effective implementation. I am less concerned than Mr. Walker about OMB’s aggressive goals to shorten the decision cycle for A-76 studies. Major changes in past practice will have to occur to make OMB’s goals feasible, but I believe the goals are worth striving for. DoD’s competitive sourcing office believes that processes can change to achieve these goals. As noted above, shorter cycle times should reduce the negative effects of competition on employee morale.

¹⁹ The media have tended to overlook or underplay the fact that all Panel members supported the ten principles stated in the Commercial Activities Panel’s final report (Commercial Activity Panel, 2002, pp. 33-36).

²⁰ Best commercial sourcing practice formally recognizes the resources required to support change and justifies them, in corporate resource allocation processes, with reference to how these resources will affect a firm’s high-level performance and cost goals. A fairly transparent ability to justify investments in change is one key advantage of using high-level strategic metrics

to drive make-or-buy decisions rather than metrics like OMB's percentage of commercial positions reviewed.

²¹ Competition can more easily improve performance when it is flexible enough to capture the buyer's priorities and reflect them in the decision of which source matches them most completely. A "past performance" criterion uses a source's performance on similar work in the past to measure how well it will perform a workload being competed. Past performance is heavily used in commercial competitions that will result in performance-based contracts. Performance-based contracting is the preferred approach to buying services in DoD today. The Federal Acquisition Regulation easily accommodates the use of past performance as a source selection criterion in private-private competitions. Current congressional legislation prohibits DoD from using best-value criteria, including past performance, in any public-private competition (10 USCS § 2462). This denies the use of an essential tool in public-private DoD competitions that Congress has allowed in private-private competitions for decades.

²² Loss of pensions will become a smaller issue each year as the federal employees with Civil Service Retirement System (CSRS) pension plans phase out of the federal work force and remaining employees use the Federal Employees Retirement System (FERS). But loss of pensions remains an important issue today. One way to deal with this problem (and others), which the DoD Business Initiatives Council (BIC) has explored, is the use of a Transitional Benefit Corporation. For details, see Sorett, 2001.

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